

resulting options position with a short sale in applicable Nasdaq/NM securities as if such security was a designated Nasdaq/NM security. The Floor Official or Order Book Official who is notified of such a transaction must file a report describing the transaction with the Department of Market Surveillance and must provide the market maker with a copy of the report. The market maker, in turn, must maintain a copy of the report to demonstrate the transaction was bid test exempt. The Commission believes that this provision is consistent with the NASD's interpretation regarding hedging activities associated with the facilitation of customer transactions in options and that the procedures for reporting a transaction under the provision will ensure adequate monitoring.¹⁵

As noted above, Proposed Interpretation .03 will give a market maker organization more flexibility to manage its market making obligations by allowing a nominee of such organization to affect short sales of securities as bid test exempt even though the nominee has not designated such securities as bid test exempt eligible, provided that the securities have been designated bid test exempt eligible by another nominee of the market maker organization, and further provided that the bid test exempt eligible nominee is not present on the trading floor. The Commission believes this is a reasonable provision designed to address instances where a market maker nominee is absent from the trading floor due to illness, personal, or other business. The Commission believes that this provision is consistent with the intent of the market maker exemption to the short sale rule, in that the exemption continues to be limited to those Nasdaq/NM securities which are used to hedge options transactions in the primary classes in which the market maker organization makes markets. The CBOE will monitor the use of this provision pursuant to the short sale exemption surveillance procedures currently in place.¹⁶

Finally, it should be noted that CBOE Rule 15.10 was approved on a temporary basis, to remain in effect so long as there exists a market maker exemption to the NASD's short sale

rule.¹⁷ Accordingly, the changes approved herein also are being approved for the same temporary period.

IV. Conclusion

For the reasons discussed above, the Commission finds that the proposal is consistent with the Act, and, in particular, Section 6 of the Act.

It Is Therefore Ordered, pursuant to Section 19(b)(2) of the Act,¹⁸ that the proposed rule change (File No. SR-CBOE-94-38) is approved on a temporary basis, to remain in effect so long as CBOE Rule 15.10 remains in effect.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹⁹

Margaret H. McFarland,

Deputy Secretary.

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[Release No. 34-35282; File No. SR-CBOE-94-53]

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the Chicago Board Options Exchange, Inc. Relating to a Determination of the Exchange's Office of the Chairman Pursuant to Exchange Rule 4.10(b)(3) That Certain Financial Requirements be Imposed Upon Member Organizations That Clear Options Market Maker Transactions

January 26, 1995.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),¹ notice is hereby given that on December 22, 1994, the Chicago Board Options Exchange, Inc. ("CBOE" or "Exchange") filed with the Securities and Exchange Commission ("Commission") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the self-regulatory organization. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

¹⁷ See Securities Exchange Act Release No. 34632, *supra* note 4. If the NASD later amends its short sale rule in a manner that affects the market maker exemption, including its definition, conditions, and requirements, the CBOE and other options exchanges might be required to amend their own companion market maker exemption rules so that market makers may avail themselves of any continued market maker exemption. *Id.*

¹⁸ 15 U.S.C. 78s(b)(2) (1988).

¹⁹ 17 CFR 200.30-3(a)(12) (1993).

¹ 15 U.S.C. 78s(b)(1) (1988).

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

The CBOE proposes to issue a regulatory circular ("Regulatory Circular") concerning a determination by the Exchange's Office of the Chairman pursuant to Exchange Rule 4.10(b)(3) that certain financial requirements be imposed upon member organizations that clear options market maker transactions.²

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the self-regulatory organization included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The self-regulatory organization has prepared summaries, set forth in Sections (A), (B) and (C) below, of the most significant aspects of such statements.

(A) Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

The purpose of the proposed Regulatory Circular is to inform the Exchange's membership that, acting pursuant to its authority under Rule 4.10(b)(3), the Office of the Chairman has determined that it is necessary to impose certain financial requirements upon Exchange members that clear the transactions of options market makers. The Exchange believes that for such members to continue in business without such requirements has the potential to threaten the financial integrity of Exchange market maker transactions.³ The Office of the Chairman has determined that the current method of calculating options

² The proposed Regulatory Circular is available from the Commission and the CBOE. See *infra* Part IV.

³ Exchange Rule 4.10(b)(3) provides that the Office of the Chairman may impose additional financial and operational requirements on a member that clears market maker trades when the Office of the Chairman determines that the member's continuance in business without such requirements has the potential to threaten the financial or operational integrity of Exchange market maker transactions. Rule 4.10(b)(7) provides that the Exchange shall file notice with the Commission in accordance with the provisions of Section 19(d)(1) of the Act of all final decisions to impose extraordinary requirements pursuant to Rule 4.10(b)(3). In addition, the Exchange has elected to file the Regulatory Circular as a proposed rule change under Section 19(b)(1) of the Act.

¹⁵ See letter from Richard G. Ketchum, Chief Operating Officer and Executive Vice President, NASD, to David A. Dami, First Vice President & Associate General Counsel, Global Derivatives, Paine Webber, Inc., dated September 13, 1994.

¹⁶ See letter from Patricia Sizemore, Director, Department of Market Surveillance, CBOE, to Francois Mazur, Attorney, Division of Market Regulation, Commission, dated January 25, 1995.

market maker haircuts under Rule 15c3-1(c)(2)(x) of the Act is less effective in that many hedged positions receive haircuts which are excessive while the haircuts for uncovered positions do not adequately reflect their potential risk.⁴

As reflected in the Regulatory Circular, the Office of the Chairman has determined to require all exchange members that clear options market maker transactions on a proprietary or market maker customer basis to calculate options market maker haircuts in accordance with a haircut methodology developed jointly by the Exchange and the Options Clearing Corporation ("OCC") and based upon the theoretical options pricing model of Cox-Ross-Rubinstein.⁵ The haircut treatment imposed by the Office of the Chairman is the same as that described in a recent Division no-action letter.⁶ The Office of the Chairman also has determined to allow an alternative calculation of haircuts for stock index baskets in accordance with the Division's staff no-action letter dated February 27, 1986.⁷ Although the 1986 no-action letter requires an operationally more cumbersome calculation, the Exchange believes the resulting lower haircuts more effectively recognize the hedging benefits of partial stock baskets offset by options and futures.

To the extent that this Exchange imposed haircut treatment would result in lower charges than currently required by Rule 15c3-1 under the Act, the February 27, 1986 and March 15, 1994 no-action letters provide the basis for the lower charges. To the extent that the Exchange imposed haircut treatment would result in higher haircuts, such greater requirements are being imposed

pursuant to the Exchange's authority under its Rule 4.10(b)(3).

To date, all but two Exchange members which clear the transactions of independent options market makers are calculating haircuts pursuant to the methodology described in this filing. We understand that the remaining two Exchange members are currently taking the operational steps necessary to comply with these parameters, and that these firms will be operationally prepared to calculate haircuts under these parameters by no later than early January 1995.

All Exchange market makers have been provided timely and adequate notice of the impending haircut changes through Exchange regulatory circulars and direct communication from their clearing members. The Exchange also provided several opportunities for special meetings with Exchange Financial Compliance staff to discuss the impact of the haircut changes. The new haircuts and implementation plan were also discussed at numerous meetings of the Exchange's Clearing Procedures Committee. The expected impact of risk-based haircuts was also discussed at a general meeting open to all Exchange members. It is our understanding that market makers on other exchanges have also been advised of the new charges. The implementation has proceeded smoothly.⁸

The Exchange believes that the imposition of these financial requirements is within the Exchange's authority, and that these requirements represent a more rigorous and reasoned basis upon which to assess capital charges. All market maker clearing firms are expected to be using the revised methodology of calculating haircuts by early January 1995. Nevertheless, the Office of the Chairman is using its authority under Rule 4.10(b)(3) to make it clear that the revised haircut treatment will be imposed now and equally across all positions of all options market makers, pending the Commission's consideration of a proposed rule to impose a similar

haircut treatment upon all broker-dealers.⁹

The Exchange believes that its proposal is consistent with and furthers the objectives of Section 6(b)(5) of the Act in that it will promote maintenance of fair and orderly markets and will contribute to the protection of investors and the public interest.

(B) Self-Regulatory Organization's Statement on Burden on Competition

CBOE does not believe that the proposed rule change will impose any burden on competition.

(C) Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received From Members, Participants, or Others

Written comments on the proposed rule change were neither solicited nor received.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 35 days of the date of publication of this notice in the **Federal Register** or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

- (a) By order approve such proposed rule change, or
- (b) Institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street NW., Washington, DC 20549. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Section, 450 Fifth Street NW., Washington, DC. Copies of such filing

⁴ The Exchange believes that the Commission and the Division of Market Regulation ("Division") share its concerns. In Chapter 5 of the staff's report concerning capital adequacy during the 1987 Market Break, the staff stated that, "The substantial losses of market makers * * * demonstrate that the present net capital treatment accorded to short options positions is inadequate to insure against the risk of major market movements."

⁵ See letter from Mary L. Bender, First Vice President, CBOE, and John C. Hiatt, Executive Vice President, OCC, to Michael Macchiaroli, Associate Director, Division, Commission, dated May 7, 1993.

⁶ See letter from Brandon Becker, Director, Division, Commission, to Mary L. Bender, First Vice President, CBOE, and Timothy Hinkes, Vice President, OCC, dated March 15, 1994. See also Securities Exchange Act Release No. 33761 (March 15, 1994), 59 FR 13275 (Proposed Rule Amendments to Capital Requirements for Brokers or Dealers Under the Securities Exchange Act of 1934).

⁷ See letter from Michael A. Macchiaroli, Assistant Director, Division, Commission, to David Marcus, Executive Vice President, Regulatory Services Group, New York Stock Exchange, Inc., dated February 27, 1986.

⁸ The new haircut methodology has been implemented at options market maker clearing firms on a staggered basis subsequent to thorough testing of each firm's capabilities by the Exchange, OCC, and other designated examining authorities. The first three firms began using the new haircuts on May 6, 1994. Other implementation dates were May 27, June 3, June 24, July 1, and July 22, 1994. The last two firms which clear independent options market makers are expected to have the operational capability to begin using the new haircut methodology sometime in the first quarter of 1995. One self-clearing broker-dealer also is preparing to implement risk-based haircuts; options market making is not a material part of the firm's business and a date for implementation has not yet been scheduled.

⁹ See *supra* note 6.

will also be available for inspection and copying at the principal office of the above-mentioned self-regulatory organization. All submissions should refer to File No. SR-CBOE-94-53 and should be submitted by February 23, 1995.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹⁰

Margaret H. McFarland,
Deputy Secretary.

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**Self-Regulatory Organizations;
Government Securities Clearing
Corporation; Notice of Filing of
Proposed Rule Change Relating to
Mandatory Participation in the Yield-to-
Price Conversion Process**

January 27, 1995.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),¹ notice is hereby given that on November 8, 1994, the Government Securities Clearing Corporation ("GSCC") filed with the Securities and Exchange Commission ("Commission") the proposed rule change described in Items I, II, and III below, which items have been prepared primarily by the self-regulatory organization. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

**I. Self-Regulatory Organization's
Statement of the Terms of Substance of
the Proposed Rule Change**

The proposed rule change would modify GSCC rules to require participation by members of GSCC's netting system in GSCC's yield-to-price conversion process.

**II. Self-Regulatory Organization's
Statement of the Purpose of, and
Statutory Basis for, the Proposed Rule
Change**

In its filing with the Commission, GSCC included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. GSCC has prepared summaries, set forth in sections (A), (B), and (C) below, of the most significant aspects of such statements.

**A. Self-Regulatory Organization's
Statement of the Purpose of, and
Statutory Basis for, the Proposed Rule
Change**

(a) The purpose of the proposed rule change is to make the participation by members of GSCC's netting system in GSCC's yield-to-price conversion process mandatory. On October 16, 1992, GSCC implemented its yield-to-price conversion feature, which allows yield trades to be netted and novated on the night the trade is entered and eliminate the need for double submission of when-issued trades. At that time, in order to not impose undue operational or system burdens on certain firms, participation in the conversion process was not made mandatory.

Participation in the yield-to-price conversion process is important for a netting member and for the settlement process in general because otherwise a netting member's when-issued trades do not have GSCC's guarantee of settlement until auction date. Because of this, since October 1992, GSCC has not admitted an entity into netting system membership unless the applicant has agreed to participate in the yield-to-price process at the time of commencement of participation in the netting system. Currently, only one netting member still is not participating in the conversion process, and it is anticipated that it will commence participation in the yield-to-price process by the end of this year.

In light of the importance for a netting member to participate in the yield-to-price conversion process and given the expectation that all current netting members will be participating in the near future, GSCC wishes to make participation in the yield-to-price conversion process by netting members mandatory. GSCC recognizes that there may be temporary situations, for example when an entity commences its participation in the netting system, in which there are operational or other considerations that render participation in the yield-to-price conversion process difficult for a member. In such circumstances, GSCC will retain the ability to temporarily exempt such member from the requirement to participate in the yield-to-price conversion process. For GSCC's protection, however, GSCC will calculate such member's clearing fund deposit and forward mark allocation payment obligations as if it were participating in the yield-to-price conversion process.

(b) The proposed rule change will ensure that netting members' eligible

trades are encompassed within GSCC's netting process and therefore that settlement is guaranteed at the earliest point in time possible. Thus, GSCC believes that the proposed rule change is consistent with the requirements of Section 17A of the Act and the rules and regulations thereunder.

**B. Self-Regulatory Organization's
Statement on Burden on Competition**

GSCC does not believe that the proposed rule will have an impact or impose a burden on competition.

**C. Self-Regulatory Organization's
Statement on Comments on the
Proposed Rule Change Received From
Members, Participants, or Others**

Comments on the proposed rule change have not yet been solicited or received. Members will be notified of the rule filing and comments will be solicited by an Important Notice. GSCC will notify the Commission of any written comments it receives on this matter.

**III. Date of Effectiveness of the
Proposed Rule Change and Timing for
Commission Action**

Within thirty-five days of the date of publication of this notice in the **Federal Register** or within such longer period (i) as the Commission may designate up to ninety days of such date if it finds such longer period to be appropriate and publishes its reason for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

(A) By order approve such proposed rule change or

(B) Institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, DC 20549. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference

¹⁰ 17 CFR 200.30-3(a)(12) (1994).

¹ 15 U.S.C. 78s(b)(1) (1988).